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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	
	)	
Jurisdictional Separations Reform	)	CC Docket No. 80-286
and Referral to the Federal-State	)	
Joint Board	)	

STATE MEMBERS' REPORT

ON

COMPREHENSIVE REVIEW OF SEPARATIONS

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I. EXECUTIVE SUMMARY

The time is right for a comprehensive review of the jurisdictional separations rules contained in Part 36 of the FCC's regulations. Significant statutory, technological, and market changes in the telecommunications industry make today's network architecture and service offerings vastly different from the network and services contemplated in the current separations rules. The separations process that was ultimately codified in the Part 36 rules evolved during a time when it was presumed that intrastate and interstate telecommunications services would be provided through a regulated monopoly. This is no longer the case.

A Notice of Proposed Rulemaking (NPRM) issued in this proceeding in October 1997, generally sought comment on a variety of topics related to separations. In this report, we do not detail our initial position on each issue in the NPRM. Rather, this report highlights broad issues in separations. We believe the Joint Board must address these issues as part of its deliberations because a comprehensive review of separations was referred to the Joint Board. In our opinion, such a referral encompasses a broad range of issues and we are not limited to those contained in the initial NPRM.

The purpose of this report is to focus on issues, some of which we feel should be addressed in a future NPRM. This report should be construed as a vehicle to continue down a constructive path toward comprehensive separations reform in an expedited fashion.

Notwithstanding recent developments, Incumbent Local Exchange Carriers (ILECs) still have the opportunity to make constitutional claims of confiscation. We conclude that some form of jurisdictional separations is still required. We comment on the ability of separations in its present form to accommodate new and evolving technologies, the increasing difficulty of measuring usage, and, the changes effected by the Telecommunications Act of 1996. We articulate the need to coordinate and harmonize separations with the cost reallocations required by deregulating services. We suggest that the Joint Board examine the possibility of substantial reform to separations. Finally, we identify an interim step to comprehensive reform.

II. CONFISCATION AND THE CONTINUING NEED FOR SEPARATIONS

Incumbent Local Exchange Carriers generally provide many, if not most, of their telecommunications services over a single network. These services are a combination of intrastate, interstate and international telecommunications services. Regulatory oversight for interstate and international telecommunications services is the responsibility of the FCC. The appropriate state public utility commission has regulatory oversight for intrastate services. This dual regulatory system of a single network requires determining the revenues and costs associated with services in each jurisdiction. Separations accomplishes this by allocating telecommunications property costs, revenues, expenses, taxes and reserves between the two jurisdictions.

Historically, separations results have provided the basis for "rate-of-return" ratemaking at both the state and federal levels. Within the state jurisdiction, utility commissions attempt to set intrastate rates that, in the aggregate, allow ILECs to earn revenues equal to their intrastate costs, plus a reasonable profit on their property.[1] Federal regulators engage in a parallel process for interstate costs and property.

[1] *Smyth v. Ames*, 169 U.S. 466, 541-42 (1898); *Smith v. Illinois Bell Tel. Co.,*, 282 U.S. 133, 149-50 (1930).

The constitutional prohibition on "confiscation" underlies both state and federal ratemaking.[2] "Confiscation" means the taking of private property by the government without just compensation. The confiscation doctrine is rooted in the Constitution of the United States which prohibits uncompensated "takings" of private property.[3] The separations process provides the cost information that is the basis for determining the confiscation liability of each jurisdiction. Indeed, it may be said that the fundamental purpose of separations is to determine the potential confiscation liability of both the federal and state jurisdictions.

The confiscation issue has been intimately related to separations for most of this century. In its 1930 decision in *Smith v. Illinois, supra*, United States Supreme Court created a mandate for a separations process.[4] In reviewing intrastate telephone rates set by the Illinois Commerce Commission, the Court found that it could not make a decision without first making:

> an appropriate determination of the value of the property in the intrastate business and of the compensation receivable for the intrastate service under the rates prescribed (by the ICC).[5]

In short, before the Court could evaluate a confiscation claim based on intrastate rates, it needed to know the company's costs and revenues in the intrastate jurisdiction. Although much has changed about telecommunications in the last 70 years, telecommunications property is still

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[2] A regulated carrier may file a legal claim for confiscation of its property in a context outside ratemaking.

[3] The "Takings Clause" of the Fifth Amendment to the United States Constitution, which is applied to the states through the Fourteenth Amendment, provides: "nor shall private property be taken for public use, without just compensation."

[4] The Notice of Proposed Rulemaking (NPRM) issued in this proceeding in October 1997, generally sought comment on whether the 1930 United States Supreme Court's holding in *Smith v. Illinois, supra,* is still relevant in light of the advent of competition and the changes that have taken place in markets and regulatory philosophy.

[5] *Smith v. Illinois, supra*, 149-50.

used to provide intrastate and interstate services, and this fundamental holding in *Smith* still applies to that property.

Continuing confiscation liability at the state and federal levels also requires continuation of separations. Even if prices no longer had any relation to embedded book cost, regulators could still face unresolved confiscation issues. For example, if a state commission were to establish rates under forward-looking cost pricing, ILECs could present confiscation claims either to the individual commission(s) or to the courts. In that event, separation results would still be necessary to provide the measure by which such a claim would be evaluated. Until the probability is small that an ILEC could present a confiscation claim based upon its intrastate or interstate operations, some form of separations will still be needed.

Numerous parties have suggested that changes to regulatory methods may make it possible to abolish separations in the near future. In essence, the argument is that separated costs are no longer needed because ILEC prices are now or soon will be unrelated to embedded book costs. The argument takes three forms.

First, separations would become unnecessary if all ILEC services were priced according to a methodology based upon forward-looking economic costs rather than embedded book costs. Even though several states are now pricing unbundled network elements based on forward-looking costs, both interstate and intrastate revenue requirements, in general, continue to be established with reference to embedded book costs.[6] It is not clear when, if ever, retail rates will generally be set according to forward-looking costs, nor is it clear that the use of such costs resolves confiscation issues.

Second, separations might become unnecessary if all ILEC services were declared competitive and therefore were no longer regulated. Interexchange carriers are now largely unregulated as to price at the federal level and ILECs do offer some services that have been declared to be nonregulated in both the federal and state jurisdictions. However, the deregulation trend has been limited and has not been extended anywhere to basic local service from an ILEC, so far as we are aware.

Third, separations might become unnecessary if all ILEC services were priced under a permanent price cap plan that does not rely upon earnings or cost of service. The FCC now sets rates for larger carriers using price caps, and many states have placed larger carriers on price cap plans. However, there are numerous exceptions. The separations rules are used either directly or indirectly (through NECA average schedules) by the more than 1200 ILECs that still operate as federal rate-of-return carriers. Even for companies under price caps, many states used rate of return regulation to set rates initially, and many plans still retain elements of rate-of-return regulation, such as "low-end adjustments" (under Part 61) and "maximum earning caps." Also, several states periodically reinitialize their price cap plans and make adjustments based upon company earnings. Finally, many ILECs under federal price caps are either under rate-of-return regulation in their state jurisdiction or are under a price cap mechanism that relies in some part on reported separated earnings.

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[6] Wyoming has recently shifted to a forward-looking economic cost basis for LEC retail pricing, and no confiscation claims were filed.

In summary, three kinds of regulatory change could justify the elimination of separations. However, none has progressed sufficiently to give us confidence that separations can be eliminated quickly. While a change in the law, such as a court ruling casting doubt on the continuing validity of *Smith*, could also justify elimination of separations, it is an unlikely prospect. For these reasons, we conclude that under the present system of dual regulation of telecommunications property, some form of separations will continue to be needed for at least the next few years, even in the transition to a new competitive environment for ILECs.

The continuing need for <u>some</u> <u>form</u> of separations, however, does not compel the conclusion that any <u>particular</u> <u>form</u> of separations is required. The basic principle in *Smith* is that neither the state nor the federal jurisdiction can set rates in a way that would preclude the utility from recovering a fair return on the totality of its property essential to the appropriate recognition of competent governmental authority in each field of regulation. The key is that costs must be separated in some consistent manner - not that any one method must be used to effect that separation. We conclude, that so long as the split of costs can be accomplished in a reasonably consistent and quantifiable manner, neither *Smith* nor its Constitutional basis would be offended regardless of the manner chosen to accomplish the separation.

III. PROBLEMS WITH SEPARATIONS

A. OVERVIEW

The existing separations system, dependent in part on usage-based measurements, has been criticized by many parties as being increasingly irrelevant to cost causation and as creating unnecessary compliance costs. State commissions in many cases today are setting Unbundled Network Element (UNE) prices based upon unseparated forward looking economic costs. Price cap plans have reduced reliance on book costs in the federal and many state jurisdictions for pricing purposes. Moreover, the use of more efficient signaling technologies and packet switching means that increasing portions of the network are used only during call setup and takedown, making minutes of use based allocation factors less meaningful for allocating those portions of the network. Technological changes lessen the degree to which some network costs are driven by demand based on minutes of use.

B. THE EFFECTS OF TECHNOLOGY HAVE MADE ALLOCATIONS MORE ARBITRARY

During the 1980's, various attempts were made by the industry to bring Subscriber Plant Factor (SPF) into some "rational" relationship with Subscriber Line Usage (SLU). The resulting current 25% allocation was largely a policy compromise between the federal and state jurisdictions. Such compromises are, of course, entirely appropriate under certain circumstances, particularly when the underlying issue is the allocation of non-traffic sensitive (NTS) joint and common costs, a problem for which there is often no single economically correct solution.

Such compromises can become less reasonable, however, when changes occur to underlying facts. In fact, several technological shifts are arguably relevant to the allocation of NTS costs, including the shift from analog to digital switches, the growth of the packet switched network, and the technology-driven shifts of the boundary between traffic sensitive (TS) and non-traffic sensitive costs. Most of these changes have affected the allocation of costs between jurisdictions, even though the basic functions are unchanged. Whatever value the compromise may once have had for predictability and stability, its value may be submerged by the uncertainty of how separations will apply to the emerging and shifting technologies.

C. USAGE IS NOW MORE DIFFICULT TO TRACK

In general, to the extent that separations is not based upon fixed allocation factors such as the 25% allocator for loop costs or direct assignment, it is based upon tracking jurisdictional usage. Usage is the linchpin of separations. For switched traffic, the underlying notion is that "interstate" traffic can be segregated from "intrastate."

Even before the Internet, it was doubtful that jurisdictional traffic amounts could, in all cases, be accurately measured and counted. This affects both separations and tariffing. The separations allocation of costs normally follows the tariffing jurisdiction. However, in some instances the tariffing and jurisdictional assignment of traffic are consistent but incorrect. For example, a carrier may sell service under an interstate tariff and record the traffic as interstate usage even though the traffic is really intrastate.[7]

Internet communications, most visibly but not uniquely, create fundamental new problems for usage measurement. As most customers today experience it, Internet usage requires a chained communication. It begins with a switched call to the customer's Internet Service Provider (ISP), where it is then connected to a packet-switched network. The jurisdiction of both of these links is unresolved at present. More to the point here, however, each part of the chain creates a separations problem. The first and switched link of the chain is currently (in most cases) treated as switched intrastate usage. This shifts costs to the state jurisdiction, even though the jurisdictional nature of the communication is undetermined. In the second link of the chain, when the communication enters the packet switched network, traditional usage measurements

[7] In addition, significant voice traffic now travels over private lines, but the separations rules governing private lines are generally regarded as somewhat arbitrary. Under existing rules, a private line with 10% traffic is considered sufficiently "contaminated" with interstate traffic so that it can be sold under an interstate tariff. Therefore, a private line used primarily for intrastate purposes can be classified as an interstate line.

overlook the packet-switched part of the chain. These separations problems are of mounting importance as the Internet continues to expand, and particularly as "voice-over-internet" increases.

D. END USER CHARGES HAVE UNDERMINED THE RATE DESIGN UNDERPINNINGS OF SEPARATIONS

Separations has, throughout its history, been viewed as a way to help keep basic service rates low by assigning costs to the interstate jurisdiction, where those costs would be recovered through (usage-based) interstate toll charges. The debates about how close SPF should be to SLU, for example, were largely focused on how much cost should be recovered through interstate usage charges as opposed to local rates. Indeed, the "policy compromise" (the 25% gross allocator) described above was, at its center, a compromise between those who favored recovering relatively more costs through basic rates and those who favored recovering less.

In 1986, the Commission required some costs assigned to the interstate jurisdiction to be recovered from end users through the SLC. For all practical purposes, the SLC became part of the basic monthly charge. This means that, since at least 1986, there has been no direct relationship between the level of costs assigned to either jurisdiction and the level of basic monthly charges paid by customers. The separations process may once have provided a forum for addressing the fundamental rate design issue of flat versus usage based charges. In its current form, separations no longer provides that forum.

E. SECTION 254 OF THE TELECOMMUNICATIONS ACT OF 1996

The fundamental purpose of the Telecommunications Act of 1996 (TA96) was to mandate competition in the local exchange. At the same time, Congress in section 254 included explicit provisions in TA96 regarding the protection and advancement of universal service. Implementation of these new and explicit provisions may require accounting and separations changes.

Section 254 is designed to protect universal service. The second sentence of subsection 254(k) reads as follows:

> The Commission, with respect to interstate services, and the States, with respect to intrastate services, shall establish any necessary cost allocation rules, accounting safeguards, and guidelines to ensure that services included in the definition of universal service bear no more than a reasonable share of the joint and common costs of facilities used to provide those services.

This statutory sentence is primarily concerned with cost allocations within each jurisdiction. Each state commission must ensure that "services included in the definition of universal service" (protected services) bear no more than a "reasonable share" of joint and common costs.[8]

This statutory sentence has implications for the separations process. For example, all of the "protected services" have traditionally been tariffed in the state jurisdiction. It would, therefore, violate subsection 254(k) if interstate services, which generally are not protected services, are allocated anything less than a "reasonable share" of joint and common costs.

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[8] The services, in particular are: single-party service; voice grade access to the public switched network; DTMF signaling or its functional equivalent; access to emergency services; access to operator services; access to interexchange service; access to directory assistance; and toll limitation services for qualifying low-income consumers. CC Docket 96-45, Order of May 8, 1997, para. 61.

Compliance with the statute is more difficult, not less, if separations does not result in a reasonable allocation of joint and common cost to all jurisdictions. In summary, compliance with subsection 254(k) requires affirmative acknowledgment of its explicit requirements in three regulatory processes: separations, state ratemaking and federal ratemaking.

Separations, however performed, answers only a part of the question of what costs form the basis for any confiscation liability. With increasing competition, more and more services that have been regulated in the past, and many services that have never been regulated, are being provided on an unregulated basis using much of the same telecommunications plant that is subject to separations. Calculating the appropriate level of "regulated costs" in either jurisdiction, therefore, requires both rational rules for separating costs between jurisdictions, and consistent rules for determining what costs should be borne by regulated (as opposed to unregulated) services. As described below, it is no longer possible to rely on the operation of Parts 36 and 64 to address this issue properly.

IV. COMPETITIVE SERVICES: PART 64 AND 36 COORDINATION

The current system of accounting and separations was designed before competitive services had a large share of the telecommunications markets. Part 64 of the rules requires the pre-separations removal of costs associated with, for example, payphones and voicemail.[9] The costs associated with these nonregulated services are subtracted from accounting costs before the jurisdictional separations process further divides those costs into interstate and intrastate portions.

[9] The FCC also proposed a rule on this topic in 1996 relating to video dial tone. NPRM, CC96-112. The proposed rule was never adopted.

The existing system is inadequate for several reasons. Of primary importance is the increasing role of competition itself, some of which has resulted from regulatory change but much of which derives from technological change. Interstate toll services, for example, seem to be highly competitive throughout much of the nation. Some market sectors, such as services for business customers, seem to be quite competitive, at least in limited small geographic areas. Unfortunately, the cost exclusion mechanism in Part 64 covers only a small portion of the services that today are competitive or that might become competitive in the near future. Competitive services costs that are not officially categorized as non-regulated under Part 64 are jurisdictionally separated by Part 36.[10] Failure to allocate costs from deregulated services (or back them out completely) may over or understate the confiscation liability.

The application of Part 64 in advance of separations does not allow the states to easily address the cost allocation associated with deregulation of services they deem competitive. For example, a state might want to declare competitive services to business customers in an urban core to be deregulated.

As a result of Part 64 occurring before Part 36, it is not clear whether Part 64 allocates a portion of the joint and common cost of plant, such as loops to non-regulated services. It appears that some ILECs allocate minimal cable and wire facility investments according to Part 64. Rather, some ILECs seem to use incremental costing or "board to board" costing principles with regard to non-regulated services. This may be inconsistent with the intent of the Telecommunications Act, which, as noted above, requires that the "services included in the

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[10] Part 64 is not merely a deduction from costs already assigned to the interstate jurisdiction, but rather are deducted from the total costs before the entire Separations process begins. Therefore, Part 64 results affect state allocations resulting from Part 36 separations.

definition of universal service bear no more than a reasonable share of the joint and common costs of facilities used to provide those services."[11]

It is apparent, therefore, that any future form of separations must be closely coordinated with the cost divisions driven by the removal of services from regulation.

V. A NEW STRUCTURE

The deficiencies in the current form of separations articulated above lead us to conclude that the Joint Board should explore fundamental alterations of the basis upon which costs, and responsibility, are divided between the state and federal jurisdictions. We believe the focus of further Joint Board activity should be to explore how best to achieve the overall goals of separations with a new, more rational, structure.

While we do not endorse any particular new structure, we believe that some proposals made in response to the NPRM warrant further study and reflect in their broad scope (if not in their particulars) how separations should be reformed.

GTE and US WEST, for example, have suggested such comprehensive reform. They propose abandoning many or all current separations requirements by fundamentally changing the existing assignment of state and federal jurisdiction. These proposals offer several advantages. They may simplify administration because they eliminate some usage measurement studies. They also appear to significantly reduce the cost mis-allocations that may occur when revenues and costs are not assigned to the same jurisdiction. By establishing a common jurisdictional treatment of interstate and intrastate access charges, they may eliminate the opportunities for arbitrage.

[11] This statutory requirement is repeated in 47 CFR 64.901(c).

The GTE/US WEST proposals also split jurisdictional responsibility along lines that are tied to the jurisdiction with the greatest interest in the matter being regulated. For example, matters of a more local interest, such as the total end user rate for local service, would be regulated by the states. Matters related to interexchange rates would be subject to FCC jurisdiction. The current possibility of having two different rates for recovery of the same investment would end because "split" jurisdictional investment would be assigned to one jurisdiction or the other. A single regulatory commission would have the ability to design a telephone rate structure which is responsive to differing local conditions and needs. The current jurisdictional dispute over the authority to impose charges for different forms of end user access to the Internet would disappear.

Although the GTE/US WEST proposals would move a substantial amount of investment and expenses into the intrastate jurisdiction, they would also reclassify as intrastate a large portion of revenue currently considered interstate. These revenues include all interstate access revenue from the Subscriber Line Charges, Carrier Common Line Charges, Switching and Transport Charges, and PICC Charges. In many cases, the additional state revenue requirement and expenses would be offset by the interstate revenue that would be reallocated to the intrastate jurisdiction. But in instances where the pooling of interstate costs occurs and for average schedule companies, substantial cost shifts that may not be offset could occur by virtue of ending that pooling as envisioned by this plan.

While these proposals described above raise the prospect of dramatic improvement to the separations process, we emphasize that many issues need to be resolved before any particular structure would merit our endorsement. For example, if the state revenue requirement increase more than the increase in state revenues, we then need to explore how such an increase can be offset by interstate sources. Where interstate costs are pooled and where average schedules are used, what costs shifts might occur? How might they be mitigated? How might such a realignment impact the current and proposed high cost fund? What new regulatory mechanisms might be needed to implement realignment? How can a new separations structure complement, rather than frustrate, the universal service objectives of the Telecommunications Act of 1996, with particular attention to high cost states?

Finally, the exact nature of how the allocation would occur, how costs are recovered, and whether the FCC would preempt the states or otherwise impose requirements on the recovery of access costs could significantly impact local and interexchange rates.

VI. TRANSITIONAL REFORM OF SEPARATIONS

The state members recognize that moving immediately to a replacement for the current form of separations is impossible. For that reason, we recommend that the Joint Board consider, as an interim measure, an approach to Part 36 that minimizes the anomalies while still providing state and federal regulators with the vital "confiscation liability" information they require.

Various freeze proposals have been submitted which range from the use of a single frozen factor to freezing current factors based on a three year average (1993-95). There were a number of criticisms of these freeze proposals. We recommend that the Joint Board consider an alternative proposal which not only responds to the criticisms of the freeze proposals but also addresses the concerns which gave rise to the freeze concept. The alternative proposal averages the latest three years of separations usage factors on an ongoing basis, thereby dampening the impact of usage changes and resultant cost shifts from year to year.

The three-year rolling average proposal would be an interim solution, not the final goal of comprehensive separations reform. This proposal would include a three to five year time limit for adoption of comprehensive reform. The separations process would be monitored during that period to determine the appropriateness of continuing the proposal or moving to a replacement. This interim proposal would eliminate large fluctuations in jurisdictional allocations while other changes resulting from the 1996 Act, technology and the move toward a more competitive environment continue. This three year rolling average proposal should:

- Address concerns regarding new technology and service offerings by assuring that revenues and costs are assigned to the jurisdiction with tariff approval authority.
- Apply to all non-average schedule ILECs, thereby rejecting the idea of bifurcated procedures for large and small ILECs.
- Base all non-average schedule ILEC jurisdictional allocation factors on the most recent three-year rolling band average of usage factors.
- Apply any separations changes which have been adopted at the time of the implementation of the rolling band procedure as an adjustment to all of the three years where applicable. For example, the Other Billing and Collection change which was adopted on February 7, 1997, would be applied retroactively to the three-year period. This would also apply to any "clean up" items which may surface during the comment process.

The rolling average proposal would balance the benefits of both a freeze and the current procedures while providing a continuity of process and maintaining essential data for monitoring purposes. In addition to providing stability, this proposal would capture traditionally measured impacts of new technologies on the network by retaining a connection to network usage. Finally, it would maintain a consistent relationship between revenues and costs and should not result in a re-negotiation of jurisdictional cost shifts during the interim period.

For these reasons, the Joint Board should consider this alternative proposal as an interim step to comprehensive separations reform.

VII. CONCLUSION

The state members submit this report as requested by the FCC in its NPRM issued in October 1997. We have not addressed in detail our position on each issue in the NPRM. Instead, we have taken this opportunity to highlight some broad items related to the long term approach to comprehensive review and to issues not included in the NPRM. We are developing questions to complement the items identified in the report and the NOPR, which should be issued in conjunction with the notice of this report. We also suggest an alternative interim approach to be fully developed with our federal counterparts until a comprehensive approach can be achieved in an expedited fashion.

To this end, we request that the FCC promptly issue a notice and establish a comment and reply cycle on this state report. Furthermore, we believe that a meeting should be scheduled promptly to explore issues to be addressed in a Recommended Decision of the Joint Board to be issued during the spring of 1999. We believe that further meetings of the Joint Board should be held to develop a Further Notice of Proposed Rulemaking, finalize other Recommended Decisions and deal with issues related to Part 36 as they arise.

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